The Evolution of ESMA and Direct Supervision: Are there Implications for EU Supervisory Governance?

Abstract

The European Securities and Markets Authority ('ESMA') was established six years ago. It, and its sibling bodies for banking, and the insurance and occupational pensions sector, emerged from the ashes of the crises, and the agencies have been the topic of much discussion in academic scholarship from a variety of perspectives. This article provides a new situating of ESMA within the broader policy context. Employing empirical observations, and rooting it within the related literature on supervisory governance (defined, broadly, as the supervisory practices and enforcement measures that contribute to governing the EU's financial set-up), it explores ESMA's pro-active use of its direct supervisory and enforcement powers, and uses this as a launching pad for reflecting on how EU supervisory governance is evolving.

Specifically, the article speculates that although ESMA is still at a relatively youthful stage with respect to its direct role, it is strengthening its reputation as a credible and pro-active supervisor, and is becoming an important driver with respect to the evolution of EU supervisory governance. This article suggests that, over time, ESMA's influence and approach could gradually result in the greater centralisation of supervisory governance at the EU level. Linked to this, the article also speculates that any such shifts in this regard will continue to develop slowly, and over time, rather than via any seismic shift. Further, although there are a number of barriers and constraints to ESMA's operation, the article suggests that none of these are intractable.

Keywords: European financial regulation; European Securities and Markets Authority; Supervisory governance.

The Evolution of ESMA and Direct Supervision: Are there Implications for EU Supervisory Governance?

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1 Introduction

The European Securities and Markets Authority ('ESMA') was established over six years ago. It, and its sibling bodies for banking, and the insurance and occupational pensions sector, emerged from the ashes of the financial crisis, and the agencies have been the topic of much discussion in academic scholarship from a variety of perspectives.[1] This article provides a new situating of ESMA within this broader policy context. Employing empirical observations, and rooting the analysis within the related literature on supervisory governance (defined, in general terms, as the supervisory practices and enforcement measures that contribute towards the overseeing of the EU's financial system), it examines the conferral on, and ESMA's use of, its direct supervisory and enforcement powers, and uses this as a launching pad for reflecting on how EU supervisory governance is evolving.

Specifically, the article speculates that although ESMA is still at a relatively youthful stage with respect to its direct operational responsibilities, it is strengthening its reputation as a credible and pro-active supervisor, and is becoming an important driver with respect to the evolution of EU supervisory governance. This article suggests that, over time, and in line with arguments observable in the related scholarship on institutional governance,[2] ESMA's

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[1] There is an emerging, burgeoning literature with respect to all three agencies. In particular both legal scholarship, and the related political economy literature examine key questions with respect to the development of the EU agencies; the constraints placed on them; and how they operate with respect to the tools they have been granted. The scholarship stemming from a political economy standpoint also particularly examines and speculates as to which particular influences assist in shaping the EU's institutional architecture. See in particular, Niamh Moloney, 'Institutional Governance and Capital Markets Union: Incrementalism or a "Big Bang"?' (2016) 13 ECFR 376; Madalina Busuioc, 'Rule-Making by the European Financial Supervisory Authorities: Walking a Tight Rope' 19 European Law Journal 111; Pierre Schammo, 'The European Securities and Markets Authority: Lifting the Veil on the Allocation of Powers' (2011) 48 CML Rev 1879. From a banking sector perspective, see Eilís Ferran, 'The Existential Search of the European Banking Authority' (2016) 17 European Business Organization Law Review 285. From a political economy angle, see e.g. Daniel Mügge, 'The Political Economy of Europeanized Financial Regulation' (2013) 20 Journal of European Public Policy 458. For related analysis, especially with respect to EU regulatory governance, the current Capital Markets Union project, and the possible deployment of a more 'experimentalist approach', see Niamh Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System?' (2016) 41 European Law Review 307; Jonathan Zeitlin (ed) *Extending Experimentalist Governance?: The European Union and Transnational Regulation* (OUP 2015).

[2] Specifically, for a discussion of such overlapping incremental developments that are observable with respect to the shape of the overall institutional design of the EU, see in particular Moloney, 'Institutional Governance and Capital Markets Union: Incrementalism or a "Big Bang"?' (n 1); Moloney, 'Capital Markets Union: "Ever Closer Union" for the EU Financial System?' (n 1).

influence and approach could gradually result in the greater centralisation of supervisory governance at the EU level. Indeed, such incremental developments can be evidenced, for instance, via the EU's current Capital Markets Union ('CMU') project. This flagship initiative aims to strengthen the EU's capital markets,[3] and has led to proposals focused on further strengthening the EU's supervisory framework (although notably this has also led to more emotive suggestions concerning the establishment of a single European capital markets supervisor).[4] Linked to this, the article speculates that any such supervisory shifts will continue to develop slowly, over time 'the way it has always happened', rather than via any seismic shift.[5] There is one caveat to this analysis, however; as the current EU set-up adjusts following the 'Brexit' decision, this could lead to a more interventionist agenda materialising from some quarters.[6]

The article is structured as follows. After this introduction, section 2 contextualises the analysis. Section 3 then uses empirical observations with respect to three case studies: credit rating agencies; trade repositories; and short selling. For clarity, the first two topics concern the conferral of direct day-to-day supervisory responsibilities on ESMA. The third relates to the distinct, but related, grant of direct emergency powers of intervention on ESMA. Section 4 considers the implications for EU financial law and supervisory governance. Section 5 concludes.

2 The Context

All three European Supervisory Authorities ('ESAs') were created in January 2011, along with the European Systemic Risk Board ('ESRB') that was mandated to oversee risk in the financial system as a whole. In conjunction with the Member State national supervisors, the ESAs, and the ESRB form the European System of Financial Supervision ('ESFS').[7] Respecting the Treaty principles of subsidiarity and proportionality, the ESFS is conceived largely as a decentralised structure and day-to-day supervision is intended, in the main, to be carried out at the Member State level by the national competent authorities ('NCAs') closest to the markets and institutions that they supervise.[8] One exception however, concerns the

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[3] This project, amongst other aims, seeks to ensure more diversified sources of finance to enable all types of company can tap the capital markets, see e.g. European Commission, 'Action Plan on Building a Capital Markets Union' (COM(2015) 468 final).

[4] Jean-Claude Juncker and others, *Completing Europe's Economic and Monetary Union: The 'Five Presidents Report'* (June 2015) 12; European Commission, *Capital Markets Union - Accelerating Reform COM(2016) 601 Final* (2016) 7. Note that the UK in particular voiced concerns about such controversial suggestions, see e.g. House of Lords European Union Select Committee, *'Whatever It Takes': The Five Presidents' Report on Completing Economic and Monetary Union* (13th Report of Session 2015–16, 12 May 2016) 42-43.

[5] Former French President Sarkozy, as quoted by Lord Pearson, *UK Parliamentary Debate* (Hansard, HL, 2 July 2009, col 328); Moloney, 'Institutional Governance and Capital Markets Union: Incrementalism or a "Big Bang"?' (n 1). See also European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (March 2017).

[6] Niamh Moloney, 'Financial Services, the EU, and Brexit: An Uncertain Future for the City?' (2016) 17 German LJ 75, 80.

[7] The ESAs replaced the former 'Level 3' committees that included the Committee of European Securities Regulators ('CESR'), ESMA's predecessor, Jacques de Larosière, *The High-Level Group on Financial Supervision in the EU: Report* (2009).

[8] Regulation (EU) No 1095/2010 Establishing a European Supervisory Authority (European Securities and Markets Authority) [2010] OJ L331/84, recital 9; Jacques de Larosière (n 7) 47. The ESFS's architecture is commonly referred to as the 'hub and spoke' model; rulemaking is centralised but the focus of supervision largely remains at the national level, European Commission, *Commission*

oversight of credit rating agencies ('CRAs').[9] Here, responsibility for direct day-to-day supervision has been transferred to ESMA.[10] ESMA has a wide range of supervisory powers over CRAs, and can also take enforcement action, including the imposition of financial penalties.[11]

The transfer of supervisory competence over CRAs has not been the sole exception to the rule, and the development of ESMA's role as a 'credible direct supervisor',[12] and as a fundamental component of the ESFS, is now evident in other areas of financial market activity. In particular, in 2012, ESMA was granted direct responsibility for the registration and supervision of trade repositories within the EU (broadly, bodies who collect and maintain records of derivatives trades), again with such functions extending to include enforcement powers.[13] The gradual expansion in ESMA's competence can also be observed in relation to short selling regulation. ESMA is granted direct powers of intervention in exceptional circumstances; it can, subject to a detailed set of procedural conditions and constraints, prohibit or impose conditions on the entry into a short sale and such measures will prevail over prior actions taken by NCAs.[14] Each of these three case studies evidence the gradual extension to ESMA's operational role over time, and each will be further elucidated upon through reflecting on the empirical facts on the ground.

3 Three Case Studies

3.1 Credit Rating Agencies

Communication: European Financial Supervision COM(2009) 252 Final (2009) 9; Eddy Wymeersch, 'The European Financial Supervisory Authorities or ESAs' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (OUP 2012) 234; Carmine Di Noia and Matteo Gargantini, 'Unleashing the European Securities and Markets Authority: Governance and Accountability after the ECJ Decision on the Short Selling Regulation (Case C-270/12)' (2014) 15 EBOR 1, 40.

[9] Jacques de Larosière (n 8) 19. CESR (ESMA's predecessor) first highlighted this issue in 2004, CESR, *Preliminary Progress Report: Which Supervisory Tools for the EU Securities Market* (2004 Ref (04-333f)).

[10] Regulation (EU) No 513/2011 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies L145/30. See e.g. ESMA, 'ESMA's Role in European and International Regulatory Cooperation' (Chief Executive Speech, 12 June 2012) who observes that bringing CRAs under the 'umbrella of EU supervision is a milestone achievement'.

[11] CRA Regulation II recitals 14, 17-18.

[12] ESMA, Strategic Orientation 2016-2020 (ESMA/2015/935) 3; European Commission, *Report on the Operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)* (COM(2014) 509 final). See also European Court of Auditors, *EU Supervision of Credit Rating Agencies –Well Established but Not yet Fully Effective* (Special Report No 22, 2015).

[13] Regulation (EU) No 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories [2012] OJ L201/1, arts 55-81; Eilis Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (OUP 2012) 152.

[14] Council Regulation (EU) No 236/2012 on Short Selling and Certain Aspects of Credit Default Swaps [2012] OJ L86/1, art 28. Although beyond the scope of this paper, ESMA will also be granted further direct powers with respect to the sale of particular financial instruments under the MiFID II/MiFIR reforms (although implementation of these rules has been postponed and is now currently anticipated for 2018).

First, what are CRAs? Put simply, they are companies that assess the credit-worthiness of issuers and financial instruments. CRAs can have a major impact on the markets as ratings actions are carefully tracked by, amongst others, issuers, investors, borrowers, and governments.[15] CRAs traditionally issued opinions on the probability of default or expected losses of companies and governments; however in the years leading up to the financial crisis, CRAs also provided ratings for more exotic financial instruments, and CRAs were close to the origin of the problems that arose with the sub-prime market in 2007. In particular, CRAs gave favourable opinions on instruments financially engineered to give high confidence to investors, who took insufficient interest in the instruments' risk characteristics, preferring to rely on a CRA's expertise.[16] As the financial crisis evolved, the CRAs were criticised, especially for failing to reflect the worsening market conditions in their ratings early enough, and then for not adjusting their credit ratings in time following the deepening crisis.[17]

Some of these issues arose especially from conflicts of interest inherent in the ratings business due to what can be termed the 'issuer-pays' model. Specifically, as a CRA was, generally, paid by the same issuer whose creditworthiness it was rating, this model created potential conflicts of interest for the CRA.[18] Although there is a counter-argument, in that CRAs must protect their reputation with investors, and balance any short-term gain from satisfying an issuer, with its long-term reputation in the market, it is questionable whether the risk of reputational loss can actually act as an effective sanction.[19] Indeed, this is especially true with the ratings of complex financial instruments during the crisis, where the fees that CRAs could obtain strongly impacted their assessments.[20] In particular, the major investment banks that brought in this work acquired much power over the agencies: if they were dissatisfied with a rating, business could be moved elsewhere.[21] Consequently, to retain a client, the rating had to 'satisfy' them, creating the possibility of influencing the overall process.[22]

In the light of this, an early round of EU reforms on CRAs was adopted in 2009: one of the first key EU regulatory responses to the financial crisis. These reforms attempted to tackle the main issues that had become apparent during the crisis,[23] and CRAs established in the EU became subject to a range of rules including a registration requirement, and provisions aimed at avoiding conflicts of interest.[24] During the eurozone sovereign debt crisis, however, CRAs

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[15] European Commission, Impact Assessment for a Regulation Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies SEC(2011) 1354, 6.

[16] European Commission, Impact Assessment Accompanying the Proposal for a Regulation on Credit Rating Agencies SEC(2008) 2746 7.

[17] Regulation (EC) No 1060/2009 on Credit Rating Agencies L302/1, recital 10.

[18] Impact Assessment CRA I (n 16) 14-20; John Coffee, 'What Went Wrong? An Initial Inquiry into the Causes of the 2008 Financial Crisis' (2009) 9 Journal of Corporate Law Studies 1, 8.

[19] Jakob de Haan and Fabian Amtenbrink, 'Credit Rating Agencies' DNB Working Paper No 278/ January 2011 accessed 13 May 2016, 8.

[20] Ibid 8.

[21] John Coffee (n 18) 9.

[22] Chris Brummer and Rachel Loko, 'The New Politics of Transatlantic Credit Rating Agency Regulation' in Tony Porter (ed), *Transnational Financial Regulation after the Crisis* (Routledge 2014) 162.

[23] It also illustrated the EU's desire to respond to, and frame the post-crisis international G-20 led agenda, see Niamh Moloney, *EU Securities and Financial Markets Regulation* (3rd edn, Oxford University Press, 2014) 648; Brummer and Loko (n 22).

[24] Impact Assessment CRA I (n 16). CRAs also became subject to rules on rating methodology; and rules seeking to increase transparency. The International Organisation of Securities Commissions' ('IOSCO') Code of Conduct for CRAs formed a basis for this first round of CRA reforms, although the

were again the subject of criticism, especially politically, with respect to the transparency and quality of sovereign debt ratings (in essence, a CRA's assessment as to the risk level associated with respect to investing in a particular country). In a similar vein to the political allegations levied at short sellers at the time, CRAs were accused of exacerbating the crisis, both through the decisions to downgrade various eurozone economies, and due to the more subjective nature of sovereign debt ratings that led to allegations of political bias.[25] Other weaknesses were also re-emphasised, including the risk of an over-reliance on ratings by market participants; and the domination of the three main US agencies operating globally: Standard & Poor's; Fitch; and Moody's.[26]

The result of this was further reforms to the rules, and CRAs are now subject to a set of three EU regulations (collectively the 'CRA Regulation').[27] In brief, the provisions require CRAs to comply with rigorous rules of conduct to mitigate possible conflicts of interest, and to ensure sufficient transparency of credit ratings and the ratings process.[28] There are also specific requirements in relation to rating methodologies. Further, reflecting the impact of politicisation on the regulatory process, there are detailed provisions on the approach to be taken to sovereign debt ratings.[29] The reforms also introduce measures to reduce an over-reliance on credit ratings,[30] as well as a new civil liability regime.[31.] From the supervisory perspective, oversight of CRAs is also the first exception to the rule that, by in large, day-to-day supervision should be carried out at the national level.

Before ESMA took over the supervisory reins in July 2011, the rules provided for a type of 'college-type' supervision over CRAs that enabled all relevant national supervisors to participate in registering and supervising a CRA, in conjunction with a coordinating function via the Committee of European Securities Regulators ('CESR'), ESMA's predecessor.[32] This rather complex supervisory framework was never considered to be a long-term solution for CRA oversight, however,[33] and it was recognised there would be considerable advantages (especially factoring in the specificities and global nature of the ratings industry) in having

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EU rules were stricter and more specific than the international code, see further IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies* (note that the IOSCO Code was also the subject of substantial revisions in 2008 in the light of the crisis, and most recently revised in 2015), IOSCO, *Code of Conduct Fundamentals for Credit Rating Agencies (Final Report)* (2015).

[25] Brummer and Loko (n 22) 168. Specifically, CRAs form their opinion on sovereign States based on a combination of both qualitative and quantitative considerations, including economic and fiscal history; default history; assessment of the political situation; and policy developments in a particular country. Such ratings are important from a credit market perspective as well as for financial stability: if a sovereign rating is changed, it can have a 'cascade' effect on other rated entities (such as banks) as sovereign ratings are usually a factor in the determination of other ratings. Further, during the recent crises, sovereign ratings also experienced high levels of volatility (both in relation to the number of downgrades and upgrades, as well as the frequency of ratings).

[26] Impact Assessment CRA III (n 15) 4-5; 7.

[27] CRA Regulation; CRA Regulation II; Regulation (EU) No 462/2013 Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies L146/1. The set of CRA reforms will be referred to as the 'CRA Regulation', although reference to an individual regulation will be made where relevant.

[28] CRA Regulation III, recital 1.

[29] CRA Regulation, art 8; art 8a.

[30] Ibid arts 5a-5c.

[31] Ibid art 35a.

[32] Ibid, recital 46, art 29; European Commission, Impact Assessment for a Regulation Amending Regulation (EC) No 1060/2009 on Credit Rating Agencies SEC(2010) 678, 14.

[33] CRA Regulation, recital 51; CRA Regulation II, recital 8.

centralised EU oversight of CRAs.[34] It is also pertinent to observe that this transfer of supervisory competence from the national authorities to ESMA occurred relatively smoothly. Two main factors made this a less risky prospect for Member States: first, there were no major national interests at risk given the domination of the three key US agencies in the ratings business; and second, CRAs were a small (albeit influential) part of the financial markets, meaning the agencies were unlikely to require a Member State bailout that could risk implicating national taxpayers.[35]

Finally, why is ESMA's approach to supervising CRAs worthy of discussion? First, regardless of who supervises them, their regulation and oversight is an important and evolving issue. In particular, despite the considerable post-crisis efforts to stimulate competition in the CRA industry, the market remains oligopolistic, meaning it is vital that CRAs are subject to a tough regulatory framework that is backed up by a robust supervisory and enforcement regime.[36] Further, as CRAs based in one country can issue ratings that have a pan-EU reach, it is, in principle, logical to transfer the 'watchdog' role to ESMA: it should be more effective and efficient for an authority with EU-wide reach to exercise direct oversight.[37]

3.1.1 ESMA and CRAs: Direct Supervision

The thinking on supervision varies with the times. Specifically, stances are shaped and driven by the wider economic and political climate. For example, in the pre-crisis days, a more light-touch, 'principles based' approach was especially in vogue in the UK; although, unsurprisingly, this fell out of favour with the crisis, and post-crisis thinking has heralded a wider, global shift towards a more 'risk-based' supervisory model.[38] What is a risk-based approach? It has been defined as the use of systematised frameworks of inspection or supervision to manage regulatory or institutional risk, the focus being *not* on the potential risks that individuals or the economy face by a firm, but the risks the regulator faces in failing to achieve its objectives.[39]

In essence, this type of model requires supervisors to make choices, and to decide what types and levels of risk they are prepared to tolerate, and such decisions will be especially influenced and dictated by the broader political backdrop, and the related risk to the regulator's reputation.[40] Consequently, the higher the political salience of a risk, the less a

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[34] CRA Regulation, recital 51; Impact Assessment CRA II (n 32).

[35] Eilis Ferran, 'Financial Supervision' in Daniel Mügge (ed), *Europe and the Governance of Global Finance* (OUP 2014) 34; Niamh Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – a Tale of Two Competences: Part (2) Rules in Action' (2011) 12 European Business Organization Law Review 177, 204.

[36] See e.g. European Commission, 'Report on the Credit Rating Agency Market' (COM(2016)664) 21.

[37] Impact Assessment CRA II (n 32), 4; European Commission, Impact Assessment for a Regulation Establishing a European Securities and Markets Authority SEC(2009) 1235, 26.

[38] See e.g. Financial Stability Board, *Increasing the Intensity and Effectiveness of SIFI Supervision: Progress Report to the G20* (2012); Julia Black, 'Regulatory Styles and Supervisory Strategies' in Niamh Moloney, Eilis Ferran and Jennifer Payne (eds), *The Oxford Handbook of Financial Regulation* (OUP 2015) 13.

[39] Julia Black, 'Risk-Based Regulation: Choices, Practices, and Lessons Being Learnt' in *Risk and Regulatory Policy: Improvign the Governance of Risk* (OECD Publishing 2010) 187-8; Black, 'Regulatory Styles and Supervisory Strategies' (n 38).

[40] Black, 'Risk-Based Regulation: Choices, Practices, and Lessons Being Learnt' (n 39) 193. Broadly, it involves the regulator developing decision-making procedures in order to prioritise regulatory

supervisor's risk tolerance is likely to be in that area.[41] Applying this to CRA oversight, ESMA's risk model focuses particularly on financial stability and likely regulatory failure, a stance on a par with broader post-crisis political attitudes with their emphasis on the prevention of financial market instability and systemic risk.[42] The endorsement of a risk-based model by ESMA is also likely to help ensure the continued political confidence in its ability to perform its operational role, which may indirectly bolster its credibility as a direct supervisor.[43]

3.1.2 An Illustration: Sovereign Ratings Investigation

In terms of specifics, ESMA is granted a broad set of direct supervisory powers ranging from information requests to the ability to conduct on-site inspections and investigations.[44] In practice, ESMA has concluded a number of examinations (individual and thematic) including with respect to the more politically delicate area of the issuance of sovereign ratings.[45] Although this investigation was carried out before the final set of CRA amendments were introduced, it is helpful to reflect on as it exhibits ESMA's willingness to tackle the more sensitive areas on its watch,[46] and illustrates that its risk tolerance will be lower in this politically salient sector.

ESMA's sovereign ratings report was highly critical, identifying a wide number of concerns and deficiencies that could compromise the independence of the process, and the quality of such ratings.[47] Issues included senior management involvement in rating activities; disclosure of upcoming actions to unauthorised third parties; significant delays in publishing ratings; and allocation of lead responsibilities to junior staff. Individual remedial action plans were set, and ESMA continued to monitor and assess their implementation as part of its on-going supervisory work, which subsequently led to enforcement action being instigated against Fitch (further discussed in section 3.1.7 below).[48] Aside from the political aspects, the investigation demonstrates ESMA's enthusiasm for setting itself challenging targets and for engaging in ambitious and sensitive work. Pragmatically, such operations also enable it to

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activities and utilise resources (especially relating to inspection and enforcement) based on an assessment of the risks a firm poses to the regulator's objectives.

[41] Note that aside from the influence of political considerations, risk-based frameworks face other risks including model risk (the risk the model fails to encapsulate all relevant risks) and implementation risk (the risk the model is implemented inadequately), see ibid 186.

[42] ESMA, *2013 Annual Report: Credit Rating Agencies* (ESMA/2014/151) 27-8.

[43] Black, 'Risk-Based Regulation: Choices, Practices, and Lessons Being Learnt' (n 39) 193-4.

[44] CRA Regulation II, art 23b-art 23d. ESMA's powers are articulated in detail in line with *Meroni*.

[45] Other thematic investigations focused on bank rating methodologies; and the monitoring of structured finance ratings, see e.g. ESMA, *Investigation into Structured Finance Ratings* (ESMA/2014/1524).

[46] Moloney, *EU Securities and Financial Markets Regulation* (n 23) 674.

[47] ESMA, *Sovereign Ratings Investigation* (ESMA/2013/1775).

[48] ESMA, *2014 Annual Report on the Supervision of Credit Rating Agencies and Trade Repositories* (ESMA/2015/280) 20. ESMA also subsequently conducted supervisory work on the compliance of the CRAs with the sovereign ratings disclosure requirements introduced by the CRA III Regulation (such additional measures included requesting CRAs publish sovereign and related ratings outlooks on a Friday after the close of business; clearly stating whether ratings were solicited or unsolicited; and requesting that CRAs notify a rated entity at least 24 hours before any public disclosure).

learn quickly about the CRA industry, and its 'hands on' approach contributes to it strengthening its reputation as a supervisor who wishes to drive change in the industry.[49]

3.1.3 ESMA and CRAs: Ex Post Enforcement

Particularly given the oligopolistic nature of the CRA industry, ex ante monitoring and supervision needs to be accompanied by effective ex post enforcement mechanisms in the event there is non-compliance. Such a system needs to, first, provide a deterrent effect to keep at bay the risk that CRAs will breach the rules, and second, where an infringement is committed, be capable of imposing a sufficiently strong penalty to compel a CRA to restore the situation.[50]

Constitutionally, conferring direct enforcement powers on ESMA was controversial.[51] In particular, this was due to the long established constitutional constraints on the delegation of powers to EU agencies under the seminal *Meroni* doctrine.[52] Specifically, although clearly defined executive powers, which can be subject to strict review, can be delegated to EU agencies; discretionary powers that imply a wide measure of flexibility cannot. With the *Meroni* constraints in mind, the European Commission (the 'Commission') initially sought to retain the ability to apply penalties itself,[53] and although ESMA was eventually allocated a set of direct enforcement tools, linked to *Meroni*, its discretion is especially restricted in this regard.[54] In particular, there is a highly detailed procedural framework articulated in the CRA rules with which ESMA must comply.[55] Although rather technical, the main 'bones' of this regime are set out briefly below in order to support the subsequent analysis.

Procedurally, where ESMA concludes there are serious indications of the possible existence of facts liable to constitute an infringement of the rules,[56] a rigorous process must be followed. First, an independent investment officer ('IIO') will be appointed to investigate.[57]

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[49] ESMA, *2013 Annual Report: Credit Rating Agencies* (n 42).

[50] See e.g. Impact Assessment CRA II (n 32) 27.

[51] Ibid 30-31; House of Lords European Union Select Committee, (7th Report of Session 2010-2011, 10 November 2010), 70-72.

[52] Case 9/56 *Meroni v High Authority* [1957 and 1958] ECR 133.

[53] E.g. Impact Assessment CRA II (n 32) 30-32. As Moloney observes, the Commission Impact Assessment Board highlighted *Meroni* concerns in relation to the justification of ESMA's supervisory and enforcement powers. It queried why *Meroni* concerns were only raised in the context of sanctioning powers, and not with respect to ESMA's registration and supervision powers. The second report highlighted the same concerns (although it acknowledged that the justification was somewhat improved), European Commission, *Opinion on Impact Assessment on CRA II Proposal* (Ref. Ares(2010)108790, February 2010); European Commission, *Resubmitted Opinion on Impact Assessment on CRA II Proposal* (Ref. Ares(2010)205437, April 2010); Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – a Tale of Two Competences: Part (2) Rules in Action' (n 35).

[54] Moloney, *EU Securities and Financial Markets Regulation* (n 23) 674.

[55] CRA Regulation II, art 23e.

[56] Annex III lists infringements and these include: conflicts of interest, organisational or operational requirements, as well as obstacles to the supervisory activities, and infringements to the disclosure provisions.

[57] CRA Regulation II, art 23e.

On the basis of an IIO's findings, and having heard those subject to the investigation, [58] ESMA's Board of Supervisors will decide if an infringement has been committed. If so, it shall take a supervisory measure, and potentially (where an infringement is committed intentionally or negligently), impose a monetary penalty. Supervisory measures are non-financial and can include, for instance, withdrawing a CRA's registration; and issuing a public notice.[59] ESMA must notify any such decision to the CRA (as well as the NCA, the Commission, and the other ESAs) and has to make public the decision on its website within 10 working days from the date it was adopted.[60] This includes making public that the decision can be appealed to the Board of Appeal of the ESAs.[61]

Where an infringement has been committed intentionally or negligently, [62] ESMA can impose a fine.[63] Bearing in mind the *Meroni* concerns, ESMA's powers are especially restricted and are subject to a detailed and rather rigid framework.[64] The rules lay down minimum and maximum basic amounts depending on the infringement: for instance, for the lowest category of infringement, sanctions range from 10,000 to 50,000 euro; and the highest category ranges from 500,000 to 750,000 euro (with 750,000 euro being the maximum basic amount that can be imposed for a first infringement).[65] The basic amount can be adjusted, if need be, taking into account aggravating or mitigating factors.[66] There is also a ceiling whereby a fine is not to exceed 20 per cent of the annual turnover of the CRA in the preceding business year.[67] The fines must be publicly disclosed unless exceptional reasons exist.[68] Enforcement is governed by the civil procedure rules in the Member State in the territory of which it is carried out,[69] enforcement can be suspended only by the Court of Justice of the European Union ('CJEU'), which can also review ESMA's decision, and annul, reduce, or increase a fine imposed.[70]

ESMA's Board of Supervisors also has the power to impose a periodic penalty, which is designed to compel action by a CRA to put an end to an infringement.[71] Such payments are to be 'effective and proportionate' and are to be imposed on a daily basis until the CRA

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[58] Ibid art 36c. Note in this regard, the Commission has published additional rules of procedure to be followed by ESMA, Commission Delegated Regulation 946/2012 on Rules of Procedure on Fines Imposed to Credit Rating Agencies by ESMA L282/23.

[59] CRA Regulation II art 23e(5); art 24(1).

[60] Ibid art 24(5).

[61] Ibid art 24(5); Regulation 1095/2010, art 60.

[62] According to art 36a(1), an infringement is intentional if ESMA finds objective factors demonstrating the CRA or its senior management acted deliberately to commit the infringement.

[63] CRA Regulation II art 23e(5); art 36a.

[64] Moloney, *EU Securities and Financial Markets Regulation* (n 23) 675.

[65] CRA Regulation II, art 36a. To determine whether the basic amount of the fine should be in the lower, middle, or higher end of the limits, ESMA shall have regard to the CRA annual turnover in the previous business year.

[66] Annex IV provides that, based on mitigating or aggravating factors, adjustment coefficients will be applied.

[67] CRA Regulation II, art 36a(4). Further, where the CRA has benefitted from the infringement, the fine shall be at least equal to that financial benefit.

[68] Ibid, art 36d(1). Such exceptional reasons include where public disclosure would damage financial markets or cause 'disproportionate damage' to the parties involved.

[69] Ibid art 36d(3).

[70] Ibid art 36d(3); art 36e.

[71] Ibid art 36b.

complies.[72] Notwithstanding this, the provisions specify that the amount of the payment shall be three per cent of the average daily turnover and that a payment may not be imposed for more than six months.[73] Again, before such a penalty is imposed, the same procedural framework applies as for fines.[74] The rules do not provide for criminal sanctions but ESMA can refer matters for criminal prosecution to the relevant national authority.[75]

Although the inflexible framework surrounding ESMA's enforcement powers cannot be avoided due to the legal sensitivities, the current level of sanctions that ESMA can impose do not seem proportionate to the turnover of the major CRAs in the industry (which was estimated as being as high as $2.4 billion in 2015).[76] This issue will be returned to when analysing the fines ESMA has imposed so far in practice, but it is pertinent here to touch on the approach of ESMA's overseas counterpart, the US Securities and Exchange Commission ('SEC'). In particular, the SEC has never been 'backward at coming forward' in imposing tough sanctions, including on offending CRAs. By way of illustration, in October 2015, the SEC charged the US arm of a CRA (DBRS) with misrepresenting that it would monitor the ratings of complex instruments on a monthly basis as detailed in its surveillance methodology.[77] To settle the charges, DBRS paid nearly 6 million dollars, received a censure, and agreed to retain the services of an independent consultant to improve its internal controls.[78]

One needs to be cautious about cursory comparisons between ESMA and the SEC (that are by no means equivalent), yet the SEC action helps to illustrate that the possible fines that ESMA can impose are unlikely to have a dissuasive impact on a large CRA in practice. It is true that sanctions are only one instrument in ESMA's enforcement toolkit,[79] and so in theory the requirement for ESMA to publicly disclose the outcome could assist in influencing CRA behaviour for the better. Nevertheless, given that the threat of reputational loss has failed to act as a deterrent on CRAs in the past, it is debateable whether this tool can provide any meaningful impact in this area.

3.1.4 Enforcement Powers in Practice

The table below sets out a brief summary of the three CRA enforcement actions concluded by ESMA at the time of writing. In general, the cases all relate to a number of CRA internal control failures, including with respect to the retention of adequate records; inadequate compliance functions; and infringements of the rules concerning non-disclosure of information to unauthorised third parties.

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72 Delegated Regulation 946/2012, art 36b(2).

73 Ibid arts 36b(3)-(4). This is reduced to two per cent in the case of natural persons.

74 CRA Regulation II arts 36c-e; Delegated Regulation 946/2012.

75 CRA Regulation II art 23e(8).

76 European Commission, 'Report on the Credit Rating Agency Market' (n 36) 18; IMF, *EU Technical Note on ESMA* (IMF Country Report No. 13/69, March 2013) 18; ESMA, *ESMA Sanctioning Powers under EMIR and CRAR: Letter to European Commission* (January 2017)

77 SEC, *DBRS Administrative Proceedings* (Release No. 76261, October 26, 2015).

78 Ibid 8-12; SEC, 'SEC Charges Credit Rating Agency with Misrepresenting Surveillance Methodology' (October 2015) <https://www.sec.gov/news/pressrelease/2015-246.html> accessed 21 July 2016.

79 E.g. Baldwin and Black refer to there being a pyramid of sanctions ranging from ex ante supervision and monitoring to more intrusive enforcement mechanisms in the event of non-compliance, see e.g. Robert Baldwin and Julia Black, 'Really Responsive Regulation' (2008) 71 Modern Law Review 59.

ESMA Enforcement Action

Enforcement Measures	Number	Parties
Public Notices	3	S&P (June 2014) DBRS (June 2015) Fitch Ratings (July 2016)
Other Non-Monetary measure	-	-
Fines	2	DBRS: €30,000 (June 2015) Fitch: €1,380,000 (July 2016)
Periodic Payments	-	-

3.1.5 First Public Notice: S&P

The first case to be concluded resulted in a public notice censuring Standard & Poor's ('S&P') for failing to meet some of the organisational requirements set out in the CRA rules.[80] In brief, the facts concerned S&P's production of 'Banking Industry Country Risk Assessments' ('BICRAs'), which, according to S&P, were not credit ratings but an assessment of the banking systems in particular countries.[81] Nevertheless BICRAs were maintained in the same internal database as credit ratings and were displayed on its web-based Global Credit Portal ('GCP') (one of the methods S&P used to disseminate its credit ratings and other financial information products). The predictable result was that BICRAs were treated as credit ratings, and no effective action was taken by S&P to address the implications this could have.[82]

This led to the incident in the midst of the sovereign debt crisis, when an attempt to change an incorrect display of the BICRA for France triggered an email alert to S&P subscribers, erroneously informing them that S&P had downgraded its ratings of France (specifically, the email stated in its header, 'France (Republic of) (Unsolicited Ratings): DOWNGRADE').[83] Understandably, such an error, coming in the midst of the crisis, led to uproar in France, amid considerable speculation that the worsening state of France's public finances could result in it losing its prized triple A status.[84]

ESMA concluded that the incident resulted from control failures within S&P's organisation; there was a clear lack of responsibility for the project, the relevant staff appeared inadequately informed, and they did not demonstrate sufficient or necessary understanding as to what was taking place.[85] There was also a lack of effective oversight and responsibility: in

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[80] ESMA, *2014 Annual Report on the Supervision of Credit Rating Agencies and Trade Repositories* (n 48) 23.

[81] ESMA, *Decision of the Board of Supervisors: S&P Public Notice* (ESMA/2014/544) 4.

[82] Ibid 4.

[83] Ibid 3-4. According to Reuters, S&P was also criticised at the time for taking nearly two hours to correct the mistake, by which point the market had closed, 'EU Watchdog Censures S&P for French Rating Cut Error' *Reuters* (3 June 2014) <http://uk.reuters.com/article/uk-esma-s-p-idUKKBN0EE0KJ20140603> accessed 18 July 2016.

[84] Sam Fleming and Hugh Carnegy, 'S&P Censured for Erroneous France Downgrade Alert' *Financial Times* (3 June 2014) <http://www.ft.com/cms/s/0/326b279c-eafb-11e3-bab6-00144feabdc0.html#axzz4EluV9HBk> accessed 19 July 2016. S&P did in fact subsequently downgrade France a few weeks later although the move had little effect on France's borrowing costs.

[85] ESMA, *Decision of the Board of Supervisors: S&P Public Notice* (n 81) 5.

particular the person who had approved the upload of BICRA for France had 'completely forgotten' the information had been uploaded and was not aware BICRA was shown together with France's sovereign rating.[86]

The imposition of a non-monetary measure amounted to a cautious start to ESMA's enforcement work, and the media suggested it fell short of the tough action European politicians wished to see with respect to the credit rating industry.[87] Nevertheless, from a legal perspective, as ESMA was not satisfied the violation had occurred intentionally or negligently; a financial penalty was never an option. On a pragmatic point, this first case also demonstrates that the business of enforcement action takes time. ESMA's S&P investigation commenced in November 2011, and was only concluded over two years later. Indeed, when one reflects on ESMA's direct enforcement role, not only do the rigid procedural conditions make swift action tricky, so does the fact ESMA has to operate with relatively limited resources. For instance: in 2013 while the S&P investigation was progressing, out of 32 ESMA staff devoted to CRAs,[88] only approximately 20 per cent of staff time was engaged in day-to-day supervision and enforcement activity.[89] Likewise out of ESMA's total budget of 28.1 million euro in 2013, only 5.7 million euro (approximately 20 per cent) was allocated to CRAs.[90] In contrast (and, again, bearing in mind its different range of activities) in the UK, the Financial Conduct Authority's total budget for the same period was £432.1 million.[91] With this in mind (and this issue will be returned to in section 4 below) ESMA clearly requires a bigger 'budget envelope' to be able to function more effectively as an enforcer in practice.[92]

3.1.6 Monetary Penalties: DBRS

In June 2015, ESMA concluded its enforcement action against the European arm of the CRA, DBRS, which resulted in a public censure, plus a fine with respect to one infringement. There were three main issues: first, the CRA had a corporate governance structure in place whereby the board of directors, and an 'Executive Group' worked alongside each other without any delegation from the board, and without the two bodies having procedures in place to report to

[86] Ibid 5, 7. It also observed that there was also no clear procedure for taking rapid and effective corrective action once the error was discovered.

[87] Sam Fleming and Hugh Carnegy, (n 84).

[88] This was from a headcount of 139 ESMA staff, see ESMA, *Annual General Supervision Report* (2013) 73.

[89] Aside from this, approximately 35 per cent of staff time was engaged in thematic and individual investigations; 25 per cent in single rulebook and international cooperation; and 10 per cent in registration/perimeter and risk-analysis related activities (totalling 90 per cent of staff time), ESMA, *Report on Staffing and Resources* (ESMA/2014/939) 14.

[90] ESMA, *Annual General Supervision Report* (n 88) 68. Note however that ESMA did observe that other authorities with CRA regulatory responsibilities such as the SEC's Office of Credit Ratings had similar sized teams to those at ESMA, ESMA, *Report on Staffing and Resources* (n 89) 14.

[91] FCA, *Business Plan 2013/14* (2013) 55; Moloney, 'The European Securities and Markets Authority and Institutional Design for the EU Financial Market – a Tale of Two Competences: Part (2) Rules in Action' (n 35) 214.

[92] IMF (n 76) 14-15 that observed ESMA's budget envelope for 2013 was insufficient. This is an issue that the Commission is now consulting on; see European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (n 5).

one another.[93] Next, there were control failings: DBRS's compliance department had no formal work plan during the period under investigation, and no risk assessment activities had been carried out.[94] Finally, DBRS also failed to meet the requirements with respect to adequate records and audit trails. For example, in certain instances DBRS could not confirm whether, or to what extent, documents provided to ESMA constituted all the existing records of procedures implemented by DBRS in order to comply with the CRA rules.[95] ESMA concluded that DBRS had committed this third infringement negligently, and imposed a fine of 30,000 euro.[96]

DBRS received the 'dubious honour' of being the first CRA to be the subject of a monetary penalty,[97] yet the fine was minute; at most, a cost of doing business.[98] The small size of the sanction is all the more notable when one again contrasts it with the SEC's enforcement action against DBRS's US arm (discussed in section 3.1.3 above). Even bearing in mind that the US proceedings concerned more serious offences, the SEC's fine of almost 6 million dollars dwarfs that of ESMA's.[99]

3.1.7 Fitch

ESMA's most recent action against Fitch Ratings ('Fitch), related to a set of negligent infringements, and resulted in a 1.38 million euro fine, plus a public censure. This arose from ESMA's sovereign ratings investigation and involved three key issues. First, from December 2010 until June 2012, certain senior analysts at Fitch passed on information about forthcoming rating actions on sovereign ratings to senior persons in one of Fitch's parent companies. In particular, there were nine separate sets of email exchanges concerning actual or potential rating actions in six countries[100] that infringed the requirements not to share or disclose information on new ratings with those not involved in their production.[101] Next, Fitch failed to allow Slovenia the minimum period of time (12 hours) to consider and respond before publishing a sovereign rating, and also failed to provide it with the principal grounds on which the rating was based.[102] Finally, Fitch's internal controls were again affected by substantial shortcomings.[103]

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[93] ESMA, *2015 Annual Report on the Supervision of Credit Rating Agencies and Trade Repositories* (ESMA/2016/234) 17; ESMA, *Decision of the Board of Supervisors: DBRS Public Notice and Fine* (ESMA/2015/1048) 5.

[94] ESMA, *Decision of the Board of Supervisors: DBRS Public Notice and Fine* (n 93) 7.

[95] Ibid 8-9.

[96] Ibid 9-10.

[97] 'EU Ratings Watchdog Imposes First Fine on DBRS' *Financial Times* (29 June 2015) <http://www.ft.com/fastft/2015/06/29/eu-ratings-watchdog-imposes-first-fine-on-dbrs/> accessed 20 July 2016.

[98] 'EU Watchdog Imposes Its First Fine on Rating Agency DBRS' *Reuters* (29 June 2015) <http://www.reuters.com/article/eu-dbrs-fine-idUSL5N0ZF2C320150629> accessed 20 July 2016

[99] SEC, *DBRS Administrative Proceedings* (n 77).

[100] Greece, France, Spain, Ireland, Italy, Portugal, see ESMA, *ESMA Fines Fitch Ratings Limited €1.38 Million: Press Release* (ESMA/2016/1157).

[101] Note that although the infringements stemmed from December 2010, ESMA found breaches only between 1 June 2011 and June 2012 when the infringement provisions of the CRA rules entered into force.

[102] ESMA, ESMA Fines Fitch Ratings Limited €1.38 Million: Press Release (n 100).

[103] ESMA, *Public Notice: Fitch* (ESMA/2016/1159) 3-4. The overall penalty of 1.38 million was made up of 60,000 euro for breaching the 12 hour requirement; 825,000 euro for the internal control failings; and 495,000 euro for the unauthorised disclosures (aggravating factors applied to the internal control

A number of observations can be made about the Fitch case. First, it demonstrates that ESMA's on-going supervisory work is useful not only to improve practices and behaviour within CRAs, but also serves as a vital aid to teams in evaluating whether a CRA may be breaching the rules. Next, the Fitch penalty is the largest fine ESMA has imposed so far. Further, the case reiterates that, despite the constitutional issues, ESMA is embracing its direct responsibilities, and gradually making 'ESMA-shaped changes' [104] within the parameters it is required to operate.

Yet on the other hand, as already observed, when one juxtaposes ESMA's penalties with those imposed by the SEC, the difference remains stark. For instance, the SEC announced charges against S&P in 2015 involving fraudulent misconduct with respect to S&P's ratings of certain complex financial products.[105] To settle the charges, S&P agreed to pay more than 58 million dollars, plus a further 19 million to settle parallel cases,[106] and it was also banned for a year from rating certain products.[107] The SEC also brought related fraud charges against Barbara Duka, a former S&P manager, who oversaw these ratings, and at the time of writing this case is continuing, despite Duka's attempts to halt the use of the SEC's in-house administrative proceedings. [108]

Some commentators have seized on SEC's enforcement work and the scale of penalties imposed to argue that ESMA has been 'timid' in comparison, and that this represents a lack of willingness by ESMA to punish the agencies.[109] This argument should be further reflected on. At a basic level, there is a chasm separating the SEC's enforcement work from that of ESMA's. Further, it is clear that the imposition of severe monetary sanctions plus (where relevant) fraud charges against allegedly complicit individuals will more likely achieve the enforcement objectives of punishment and deterrence. Yet, one should remain mindful about straightforward comparisons: the US and the EU are two very different systems, and this section has identified that ESMA is required to engage in any enforcement activity within strict limits.

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failings and the unauthorised disclosures). The overall penalty also reflected the fact that Fitch had voluntarily taken measures to ensure the infringements could not be committed again in the future.

[104] Moloney, 'Institutional Governance and Capital Markets Union: Incrementalism or a "Big Bang"?' (n 1) 389.

[105] 'S&P in $77m Mortgage Securities Settlement with the SEC' *Financial Times* (21 January 2015) <http://www.ft.com/cms/s/0/2a5201cc-a188-11e4-bd03-00144feab7de.html#axzz4F86jBtIC> accessed 22 July 2016; SEC, 'SEC Announces Charges against Standard & Poor's for Fraudulent Ratings Misconduct' (January 2015) <https://www.sec.gov/news/pressrelease/2015-10.html> accessed 22 July 2016. In particular, S&P had misrepresented that it was using one approach for its ratings when in fact it was using a different methodology to make its ratings less conservative. Further, after being frozen out of the market for rating particular products, in a bid to re-enter it, S&P published a false and misleading study that omitted crucial data, and claimed that its ratings could withstand a 'Great Depression-style economic collapse'.

[106] SEC, 'SEC Announces Charges against Standard & Poor's for Fraudulent Ratings Misconduct' (n 106). The parallel cases were brought by the New York and Massachusetts Attorney General's offices.

[107] The resolution of this case also paved the way for the subsequent resolution of a settlement with the US Department of Justice, where S&P agreed to pay almost 1.4 billion dollars, Ed Beeson, 'SEC's Stiff S&P Sanction Raises Curtain for DOJ Action' (2015) <http://www.law360.com/articles/613620/sec-s-stiff-s-p-sanction-raises-curtain-for-doj-action> accessed 22 July 2016

[108] Note that the SEC has, 'SEC Can Resume Case against Ex-S&P Executive -U.S. Appeals Court' *Reuters* (13 June 2016) <http://www.reuters.com/article/sec-duka-idUSL1N1951ZT> accessed 22 July 2016.

[109] See e.g. Daniel Cash, 'Credit Rating Agency Regulation after the UK's European Union Membership Referendum' (2016) 37 The Company Lawyer 195.

Next, no consensus has emerged in the literature as to the best way to measure enforcement's intensity or effect; for instance looking at the size of a penalty imposed fails to account for the deterrent effect of reputational penalties.[110] Nevertheless, in the context of CRAs, given that the risk of reputational loss failed to act as an effective deterrent in the past, it may be questioned whether reputational penalties can ever offer a meaningful impact here. Moreover, even if publishing sanctions *could* assist in influencing behaviour for the better, the three ESMA cases (especially the Fitch action) generated only relatively limited mainstream press coverage.[111]

On the upside, this area is now a work in progress; in late 2016, the Commission proposed revisions to the CRA sanctioning system to ensure that it is credible and proportionate as a deterrent.[112] Indeed, a useful comparator for the Commission in making revisions could be its related competition enforcement regime, both with respect to the scale of the fines that can be imposed, and in relation to its explicit framework for calculations that factors in (amongst other issues) an infringement's gravity, duration, and effect.[113] With this in mind, relatively simple refinements to the CRA sanctioning regime could involve ensuring that all breaches of the rules are capable of being enforced; basing fines on a CRA's turnover (rather than turnover only being relevant as a cap); and significantly increasing the upper limit of the penalties that could be imposed.[114] Such amendments could help ensure that fines can have a dissuasive effect in practice, and bolster ESMA's credibility in its enforcement work.

3.2 Case Study 2: Trade Repositories

CRAs were not the sole exception to the rule that supervisory responsibilities should generally be orchestrated at the national level. Due especially to a lack of transparency surrounding derivatives trading (such as options and futures contracts) during the financial crisis, a post-crisis framework (the European Market Infrastructure Regulation ('EMIR')) was put in place that requires such trades to be reported to entities known as trade repositories.[115] Such entities act as a type of 'middleman' for ESMA; rather than individual firms submitting trade reports to ESMA, the information is submitted to the trade repository that maintains records that can then be made available to regulators.[116] Consequently, these middlemen are

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[110] John Armour, Colin Mayer and Andrea Polo, 'Regulatory Sanctions and Reputational Damage in Financial Markets' Research Paper Number 62/2010, 1 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1678028> accessed 24 September 2015; John Coffee, 'Law and the Market: The Impact of Enforcement' (2007) 156 University of Pennsylvania Law Review 229.

[111] For instance, on a simple Internet news search, the S&P censure generated the most broadsheet coverage, including reports by the FT; the Telegraph; and the Financial News, as well as legal coverage from Pinsent Masons (via 'Out-Law.com'). The DBRS fine was reported by Reuters, the FT, and again by Pinsent Masons. The recent Fitch case generated no major coverage aside from via Reuters, and the 'West Australian' (a devoted FT search produced no results). All three cases also received some industry specific reports (e.g. via 'the Investment Executive'; and 'Waters Technology').

[112] European Commission, 'Report on the Credit Rating Agency Market' (n 36) 20.

[113] See e.g. European Commission, *Commission Re-Adopts Decision and Fines Air Cargo Carriers €776 Million for Price-Fixing Cartel* (March 2017); European Commission, *Fines for Breaking EU Competition Law* (November 2011).

[114] ESMA, *ESMA Sanctioning Powers under EMIR and CRAR: Letter to European Commission* (n 76).

[115] Regulation (EU) No 648/2012 on OTC Derivatives, Central Counterparties and Trade Repositories [2012] OJ L201/1 (comonly referred to as 'EMIR').

[116] Finance Magnates, 'Is ESMA's €64,000 Fine of the DTCC the First of More to Come?' (2016) <http://www.financemagnates.com/institutional-forex/bloggers/esmas-e64000-fining-dtcc-first-come-

intended to play an important role in in ensuring accurate reporting in the derivatives market, and in improving transparency.[117] Akin to the transfer of supervisory responsibilities over CRAs, this transfer of power to ESMA was relatively straightforward. There were no major national trade repositories for Member States to seek control over; and such entities were unlikely to fail and require a bailout that could implicate the national taxpayer.[118]

By comparison, the same could not be said in relation to the supervision of central counterparties ('CCPs'), however. EMIR also introduced mandatory CCP clearing in relation to standardised derivatives transactions,[119] and one consequence of this was that CCPs increased in systemic importance. This had ramifications for the conferral of supervisory responsibilities,[120] and the CCP oversight system in EMIR was left largely with the national regulators, rather than being transferred to ESMA.[121] Indeed, although ESMA is granted a type of 'gatekeeper' role in relation to granting access to the EU for third country CCPs,[122] early drafts of the rules proposed that third country CCPs would obtain authorisation from each individual Member State.[123] It was only due to much lobbying by industry groups (that argued that this approach could result in discrepancies between countries and could create barriers to trade) that responsibility here was eventually transferred to ESMA.[124]

3.2.1 Enforcement Action: DTCC

With respect to ESMA's direct supervisory and enforcement powers over trade repositories, these mirror the CRA template, and ESMA has, to date, completed one enforcement action against DTCC Derivatives Repository Limited ('DTCC') resulting in a public censure and a 64,000 euro fine. DTCC is the largest EU registered trade repository and in May 2014, ESMA's supervisory team became aware of delays in DTCC providing regulators with access to the relevant trade data.[125] ESMA found that for approximately nine months, access delays occurred that increased from two days to as much as 62 days after reporting, affecting 26 billion reports.[126] The delays were due to DTCC's negligence in failing to implement data

part-1/> accessed 2 August 2016; EMIR 2012, art 81(3) sets out the range of entities to whom trade repositiories must make the data available including ESMA, NCAs supervising central counterparties, and the NCAs supervising the trading venues of the reported contracts.

117 ESMA, *2014 Annual Report on the Supervision of Credit Rating Agencies and Trade Repositories* (n 48) 31.

118 Eilis Ferran, 'Financial Supervision' (n 35) 34.

119 EMIR 2012, art 4. The EU approach was in line with the international G20 commitments to improve oversight and transparency in OTC derivatives trading following the financial crisis, *G20 Leaders Statement: The Pittsburgh Summit* (September 2009).

120 EMIR 2012, recital 52; art 22; Eilis Ferran, 'Financial Supervision' (n 35) 34.

121 This oversight system is put in place via a complex college cooperation set-up, see EMIR 2012, art 18; Niamh Moloney, 'Resetting the Location of Regulatory and Supervisory Control over EU Financial Markets: Lessons from Five Years On' (2013) 62 ICLQ 955, 965; Moloney, *EU Securities and Financial Markets Regulation* (n 23) 618.

122 EMIR 2012, art 25; Eilis Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' (n 13) 152.

123 Moloney, *EU Securities and Financial Markets Regulation* (n 23) 618; Herbert Smith, *EMIR: EU Regulation of OTC Derivatives, Central Counterparties and Trade Repositories* (March 2012) 3.

124 Herbert Smith (n 123) 3. See EMIR 2012, art 25 for the range of conditions that must be met. .

125 ESMA, *Decision Notice – DTCC Derivatives Repository Limited* (ESMA/2016/408) 3.

126 ESMA, *ESMA Fines DTCC Derivatives Repository Limited €64,000 for Data Access Failures: Press Release* (ESMA/2016/468).

processing systems capable of providing regulators with direct and immediate access. Further, once DTCC became aware of the issue, it failed to inform ESMA in a timely manner; and then took three months to establish an effective plan, even when the delays worsened.[127] ESMA concluded that DTCC was negligent in each respect, and the fine also represented aggravating factors (the infringement had continued for more than six months, it revealed systemic weaknesses in DTCC's organisation, and had a negative impact on the quality of the data maintained by it).[128]

This action is ESMA's first enforcement case against a trade repository. The fine imposed was again relatively modest, especially when one factors in the aggravating factors, although in this instance, the press reports (despite being relatively limited) suggested that this would have been 'embarrassing for one of the world's most important market infrastructure organisations'.[129] This hints at the possibility that reputational sanctions could play more of a role going forward here, although it is too early to tell, and this will ultimately also depend on the sufficiency of such coverage. More generally, the case signals that ESMA has willingly embraced this extension to its direct responsibilities.

3.3 Case Study Three: Short Selling

The third case study does not reflect the conferral of additional *day-to-day* direct powers on ESMA, yet it remains a pertinent case study to reflect on. Why? It is interwoven with the bigger picture concerning the incremental transfer of direct operational powers to ESMA over time. What is short selling? In brief, the practice concerns the sale of an asset (often shares) not owned by a seller with the aim of buying back an identical asset later for a lower price. Again in the light of (particularly political) concerns about this practice that arose during the financial and the sovereign debt crises, short selling is now the subject of a range of restrictions and requirements under the EU Short Selling Regulation ('SSR').[130]

Focusing on ESMA, it is granted direct powers to intervene in the markets to prohibit or impose conditions on short sales in exceptional circumstances, with any such measure prevailing over previous measures taken by a national authority.[131] ESMA can again only utilise these powers in exceptional, and tightly specified circumstances,[132] and it must follow a precise procedure.[133] There is one caveat to this transfer of power: sovereign debt is

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[127] Ibid; ESMA, *Decision Notice – DTCC Derivatives Repository Limited* (n 125) 6.

[128] ESMA, *Decision Notice – DTCC Derivatives Repository Limited* (n 125) 7.

[129] 'EU Watchdog Fines DTCC for Derivatives Repository Failings' *Reuters* (31 March 2016) <http://www.reuters.com/article/eu-derivatives-regulator-idUSL5N173206> accessed 3 August 2016. Again, using a simple Internet news search, Reuters, and the Financial News provided the main coverage. There was no FT coverage of this fine.

[130] For further discussion see e.g. Elizabeth Howell, 'Short Selling Restrictions in the EU and the US: A Comparative Analysis' (2016) 16 Journal of Corporate Law Studies 333; Moloney, *EU Securities and Financial Markets Regulation* (n 23) 538; Jennifer Payne, 'The Regulation of Short Selling and Its Reform in Europe' (2012) 13 EBOR 413.

[131] Regulation 236/2012 art 28(11).

[132] Broadly, where there is a threat to the orderly functioning of markets or the stability of the financial system, there are cross-border implications, and NCAs have either not taken action, or the measures taken do not adequately address the threat. Ibid art 28.

[133] Ibid art 28(4)-(5); art 28(7). The procedure includes prior consultation with the European Systemic Risk Board, prior notifications to NCAs affected by any such measure, and publication of the measure on ESMA's website.

excluded from ESMA's ambit due to political concerns as to the possible impact on countries' borrowing costs.[134]

ESMA's direct powers place it at the heart of important and delicate decisions with respect to short selling. The conferral of such powers also constitutes another significant step forward in relation to its ability to intervene directly in the markets. With this in mind, however, the UK sought to legally challenge the conferral of these powers on the basis of *Meroni* (as well as on other grounds) at the CJEU, alleging that the powers implied that ESMA was vested with a large measure of discretion, breaching the limits set by *Meroni*.[135] This legal challenge was ultimately unsuccessful, however, and the CJEU affirmed the powers, as well as the legal basis on which they were adopted.[136] Further, although it did not reject *Meroni*, on a liberal reading, it did 'clip its wings'.[137] If one adopts such a view, this could help ensure ESMA is on firmer constitutional footing going forward; on the other hand, if one takes a more restricted reading of the case, this may suggest that nothing, essentially, has changed.[138]

3.3.1 ESMA's Short Selling Powers in Practice

ESMA has not yet utilised its direct powers of intervention with regards to short sales, so it remains to be seen what use it makes (if any) of this new competence. In related developments, however, following the UK's Brexit vote in 2016, ESMA's chairman confirmed that it and the Member State national authorities had coordinated in advance and decided there was no need to use their powers on the day of the result, including in relation to imposing any short selling bans.[139]

Linked to this, however, ESMA has also issued a number of opinions over the years concerning the imposition of national emergency short sale bans, and an important shift is discernable here. In the main, ESMA has generally been supportive of such measures, yet its early opinions were notably brief, and tended to closely map the wording of the relevant rules.[140] Over time, however, ESMA has started to provide more detailed and incisive opinions,[141] including issuing its first negative opinion. Specifically, in January 2016, ESMA

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[134] Ibid, art 28.

[135] Case C-270/12 *United Kingdom v Council of the European Union and European Parliament* ECLI:EU:C:2014:18.

[136] For a comprehensive discussion of this case see e.g. Carl Fredrik Bergström, 'Shaping the New System for Delegation of Powers to EU Agencies: United Kingdom v. European Parliament and Council (Short Selling)' (2015) 52 CML Rev 219; .

[137] Eilis Ferran, 'European Banking Union: Imperfect, but It Can Work' University of Cambridge Faculty of Law Research Paper No 30/2014 <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2426247> accessed 6 January 2017.

[138] Moloney, *EU Securities and Financial Markets Regulation* (n 23) 1002-3. See also Niamh Moloney, 'International Financial Governance, the EU, and Brexit: The 'Agencification' of EU Financial Governance and the Implications' (2016) 17 EBOR 451, 461.

[139] See Huw Jones, 'Market Infrastructure Coped Well with Brexit Fallout: EU Watchdog' *Reuters* (29 June 2016).

[140] For instance, one of the first opinions ESMA issued in relation to emergency measures imposed by the Spanish regulator in 2012 contained a brief factual background before simply stating that there were adverse developments; that the measure was appropriate and proportionate, and that the measure's duration was justified. See e.g. ESMA, *Opinion on Spanish Emergency Measures* (ESMA/2012/715); see also ESMA, *Opinion on Greek Emergency Measures* (ESMA/2013/542).

[141] This included for instance its nuanced review on a three-month emergency ban imposed by the Italian regulator, CONSOB, in July 2016 on Banca Monte dei Paschi di Siena's ('BMPS') shares ESMA, *Opinion on Italian Emergency Measures* (ESMA/2016/1078).

published a relatively detailed opinion opposing the proposed extension of an emergency short selling ban by the Greek regulator, relating to the shares of the Greek financial institution, Attica Bank S.A.[142] ESMA's opinion was backed up with quantitative analysis which illustrated that the bank's pricing history did not suggest a highly fragile situation; it also observed that the bank stood for only a very small part of the Greek banking sector with respect to financial stability concerns. ESMA concluded that renewing the measure was neither appropriate nor proportionate, and identified a number of other tools that could be utilised if a significant downward spiral in the share price was to occur.[143]

The Greek regulator proceeded to implement its ban regardless, although it is probable that a combination of the reigniting of the Greek debt crisis, the broader political landscape, and the fragility of Greek relations within the EU all played a part in its decision. Nonetheless this instance remains significant for ESMA's opposition. In particular it reflects a further strengthening of ESMA's capacity as an EU supervisor, especially in its willingness to adopt an opposing position that directly criticises the stance of a national regulator.[144] With an eye to the future, it is also likely that this will not be the only occasion when a national authority and ESMA disagree on whether emergency measures should be introduced. Consequently, in the event there are differences of opinion (and although the ESMA/national authorities interactions around the Brexit vote arguably augurs well for the future), the Greek negative opinion demonstrates ESMA gaining in confidence in its ability to assert itself as an EU authority. The question therefore remains open as to whether this could result in ESMA fully embracing its direct powers of intervention in a future crisis, especially in the absence of any NCA cooperation.

4 ESMA: Implications for EU Supervisory Governance

4.1 Overview

The arguments geared towards transferring direct responsibility to ESMA over market actors, practices and activities are evident in the cases explored in section 3: direct oversight should ensure that there is greater consistency in applying the relevant rules; as well as enabling more effective and efficient supervision.[145] Further, there is a functional logic to centralising certain supervisory powers with ESMA: it is a technocrat, and oversight and enforcement of market actors or practices with a pan-EU reach is, in certain areas, efficient and, in principle, should be effective. Empirically, the three case studies all illustrate that ESMA has embraced its direct responsibilities, and that it has also been assertive in utilising its more constitutionally sensitive enforcement powers.

This section examines the implications for EU supervisory governance. First, it focuses on a number of recent reviews of ESMA that affirm ESMA's direct role and also advocate the future allocation of direct operational responsibilities to it. It then reflects on some of the key barriers and constraints to ESMA's operations, and it suggests that, given the evidence, none of these obstacles should be intractable in practice.

4.2 Enhancing ESMA's Credibility: Recent Reviews

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[142] ESMA, *Opinion on Greek Emergency Measures* (ESMA/2016/28) 6.

[143] Ibid 7.

[144] Moloney, 'Institutional Governance and Capital Markets Union: Incrementalism or a "Big Bang"?' (n 1) 418.

[145] Eilis Ferran, 'Financial Supervision' (n 35) 35.

ESMA has received considerable international and political endorsement of its direct mandate in a number of recent reviews.[146] Although perhaps not impartial, in 2013, the founding father of the ESAs, Jacques de Larosière commented that ESMA had performed well and become a recognised international authority.[147] Likewise, the Commission's first 'stocktake' of the ESAs in 2014, observed that there was broad consensus as to the efficiency and effectiveness of ESMA's direct supervision of the CRAs, as well as its mandate for supervising TRs.[148] It also indicated that further tasks could be potentially assigned to ESMA in the future including the enforcement of international financial reporting standards, the direct supervision of CCPs, and the strengthening of ESMA's direct settlement powers.[149]

With respect to ESMA's supervision over CRAs, a 2015 report by the European Court of Auditors considered that ESMA had laid down good foundations and a well established regime for effective supervision; and also set out a number of areas where there was room for improvement, including with respect to its record keeping and decision making processes.[150] The Commission's 2016 report on the CRA industry concluded that ESMA had the necessary tools to supervise the CRAs, but (as explored in section 3) emphasised that the sanctioning regime required revision to ensure it was credible and proportionate as a deterrent.[151] The 2017 Commission consultation on the operation of ESMA (and its sibling agencies) also outlined that further work was needed to 'reinforce the European dimension of supervision', and canvassed views on extensions to ESMA's direct supervisory powers, particularly in order to develop integrated capital markets.[152]

These (largely) positive endorsements all add to ESMA's standing and work as a direct supervisor, and point towards the further augmentation of its direct responsibilities over time. ESMA itself is also embracing the evolving nature of its direct role. It has merged its supervision of CRAs and trade repositories into a single department to strengthen its position as a direct supervisor,[153] and affirmed that it 'stands ready' to assume new tasks, should these be assigned, along with the appropriate resources.[154]

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[146] IMF; European Commission, *Report on the Operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)*; European Parliament, *Review of the New European System of Financial Supervision (ESFS)* (Report by Committee on Economic and Monetary Affairs (ECON): October 2013).

[147] Jacques de Larosière, 'The European System of Financial Supervision' (Speech: Public hearing on Financial Supervision in the EU (May 2013)) 12.

[148] European Commission, *Report on the Operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)* (n 12) 11.

[149] Ibid 13-14. Other areas identified for ESMA included the supervision of critical benchmarks in financial instruments and contracts; and with respect to central securities depositaries, see European Commission, *Staff Working Document Accompanying the Commission ESA Report* (SWD(2014) 261 final) 26.

[150] European Court of Auditors (n 12). ESMA only partially accepted some recommendations; for instance ESMA did not consider that a dedicated IT system was necessary given the limited number of registered CRAs. It also suggested that the direct comparison with NCAs was not proportionate in light of the numbers of registered CRAs and the size of ESMA's supervisory team compared with the NCAs' respective figures. See also, Council of the European Union, *Economic and Financial Affairs: Outcome of the Council Meeting* (9342/16 25 May 2016) 15.

[151] European Commission, 'Report on the Credit Rating Agency Market' (n 36) 20.

[152] European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (n 5).

[153] ESMA, *2015 Annual Report on the Supervision of Credit Rating Agencies and Trade Repositories* (n 93) 40.

[154] ESMA, Strategic Orientation 2016-2020 (n 12) 16.

4.3 ESMA's Direct Role: Constraints to its Operation?

ESMA is performing relatively well with respect to its broad range of direct tasks and responsibilities; nonetheless there are a number of key constraints and barriers (ranging from the practical to the political) to ESMA's current operation. This section reflects on such hurdles but it speculates that none of these obstacles should be insurmountable in practice.

The first issue concerns the institutional policy of confining supervisory powers to the ESAs by sector (securities, banking, insurance/pensions), as a type of 'mirror' to the financial industry.[155] Given that the financial crisis demonstrated the serious pitfalls in using a 'silo-based' approach to regulation and supervision, the continued reliance on such a system can be questioned. [156] In particular such an approach will not aid authorities in apprehending functionally equivalent, or emerging, risks (and in this regard it is notable that global prudential regulators are now starting to express an interest in the risks to financial stability that could be posed by the capital markets). [157] Further, a silo-based approach also creates the risk of regulatory arbitrage, whereby sophisticated market participants can capitalise on loopholes to avoid certain types of regulation. [158] Although it may prove premature to rethink the current sectorial architecture (especially factoring in political and organisational realities), and although it may be sensible to focus on 'evolution rather than revolution'; there could be, for instance, efficiency and effectiveness benefits in merging the banking and insurance/pensions agencies, whilst also widening ESMA's existing ambit.[159]

Next, as explored in section 3, there are deep-rooted legal constraints placed on ESMA under *Meroni*. Indeed although the CJEU has endorsed ESMA's powers of market intervention with respect to short sales, uncertainties remain as to the precise parameters within which EMSA can exercise its powers. This may result in ESMA being cautious, especially in exercising its more controversial direct powers, in order to avoid the risk of any future litigation.[160] Indeed, the empirical findings support this; ESMA has not used its direct short selling powers, and it has been perceived from some quarters as adopting a timid stance to its direct enforcement activity. On the other hand, were ESMA to receive clearer guidance from the CJEU going forward, this could help guarantee that ESMA was operating on firmer legal footing.

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[155] European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (n 5).

[156] FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis' (March 2009); Niamh Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (2010) 47 CML Rev 1317.

[157] See e.g. Caroline Binham et al, 'FSB Proposes Stress Testing for Asset Managers' *Financial Times* (22 June 2016) <https://www.ft.com/content/5b60ba04-387e-11e6-a780-b48ed7b6126f> accessed 6 January 2017; Financial Stability Board, 'FSB Publishes Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities' (2016) <http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document-press-release.pdf> accessed 6 January 2017; Moloney, 'International Financial Governance, the EU, and Brexit: The 'Agencification' of EU Financial Governance and the Implications' (n 138).

[158] Moloney, 'EU Financial Market Regulation after the Global Financial Crisis: "More Europe" or More Risks?' (n 156) 1360.

[159] European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (n 5) 16.

[160] Moloney, 'International Financial Governance, the EU, and Brexit: The 'Agencification' of EU Financial Governance and the Implications' (n 138); Eilis Ferran, 'European Banking Union: Imperfect, but It Can Work' (n 137).

Practical barriers also exist to ESMA's operation; an increase in ESMA's workload has not been mirrored by an equivalent increase in its human resources and budget, hampering its ability to perform.[161] Indeed although ESMA's budget has increased since its creation, its funding arrangements are not proportionate to its increasing workload and duties.[162] ESMA's precise funding set-up is also relevant here. All three ESAs are funded via a subsidy from the EU, as well as receiving contributions from the NCAs, however ESMA is also partially funded via annual fees levied on the private entities it supervises: the CRAs and trade repositories.[163] The funding ESMA receives from the EU and the national authorities is far from ideal, however: for instance, ESMA's independence could be undermined by the role of both the NCAs and the Commission in financing them.[164] Further, as ESMA grows, the contribution from NCAs could become a heavy burden for smaller Member States, creating a risk of non-payment.[165]

Again, this issue is now being tackled; the Commission is consulting on improving the ESAs' funding structures, including whether the system could be changed to a partly, or fully, industry funded model.[166] However, it remains clear that there are a number of risks, including as to 'double charges', whereby market actors could be funding both its own national authority and ESMA. Further, even if a domestic fee could be offset, this could risk negatively impacting the operation of the relevant national body.[167] Nevertheless, as the NCA and ESMA functions are not identical, perhaps it could be feasible to implement a type of dual system going forward.[168] Whichever funding model is adopted, the resources available to

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[161] See European Commission, *Report on the Operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)* (n 12) 5, 11; House of Lords European Union Select Committee, *The Post-Crisis EU Financial Regulatory Framework: Do the Pieces Fit?* (5th Report of Session 2014-2015, 2 February 2015) 42. For instance (and although the comparison with the FCA is not perfect given that their functions are not identical), in 2015, the UK's FCA had a budget of nearly £500 million and over 3000 staff. In contrast, ESMA had a budget of €34 million and a staff of 186. Figures drawn from ESMA and the FCA's 2015 annual reports, see ESMA, *Annual General Supervision Report for 2015* (2015) 64; FCA, *Annual Report and Accounts 2015/16* (2016) 9.

[162] European Commission, *Report on the Operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)* (n 12) 11; Jacques de Larosière, 'The European System of Financial Supervision' (n 147); IMF (n 76).

[163] Note that its funding sources now also include an additional NCA contribution towards delegated tasks. In 2015, ESMA was financed 40 per cent by NCAs; 26 per cent by the EU; 21 per cent by the CRAs; 6 per cent by TRs; and 7 per cent by an NCA contribution for delegated tasks, see ESMA, *Annual General Supervision Report for 2015* (n 161) 64.

[164] European Commission, *Staff Working Document Accompanying the Commission ESA Report* (n 149) 20.

[165] See IMF (n 76) 11.

[166] European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (n 5); IMF (n 86) 11; European Commission, *Report on the Operation of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)* (n 12) 11; European Commission, *Staff Working Document Accompanying the Commission ESA Report* (n 149) 20. See also ESMA, *Strategic Orientation 2016-2020* (n 12) 17 where the President of the Commission has requested there be a focus on eliminating EU and NCA budgetary contributions and that the ESAs be solely funded by the sectors they supervise.

[167] IMF (n 76) 12.

[168] See further e.g. Moloney, *EU Securities and Financial Markets Regulation* (n 23) 917 who notes that budgetary constraints on ESMA has been repeatedly identified as a risk, including from the industry, and also noting that ESMA's ability to levy fees on market actors is very limited.

ESMA should be increased considerably to enable ESMA to effectively carry out its existing operations, and to improve the likelihood of any further transfers of direct responsibilities.[169]

A further obstacle concerns a lack of political will. In particular, as explored in section 3, the main reservations stem from fiscal matters; as the Member State and national taxpayers 'foot the bill' when a market actor fails, the adage 'he who pays the piper, calls the tune' applies, with knock-on implications for the allocation of supervisory responsibilities.[170] Although the CRAs and the trade repositories were unlikely to be a source of fiscal risk for Member States, this issue is likely to present the main stumbling block to the Commission's current suggestion that direct supervisory competence be subsequently transferred to ESMA over CCPs.[171]

Closely interwoven with this, however, is the prevailing political climate. With respect to the EU's CMU project, the recent 'Five Presidents Report'[172] expressed the need to strengthen the EU's supervisory framework in order to ensure financial stability. Notably, however, the report also contained more controversial hints, including that such moves should ultimately lead to a single European capital markets supervisor.[173] Despite the rhetoric, however, it is unlikely that any such dramatic developments will materialise in the near future (absent another global crisis). The EU is not at the stage of creating a 'EU-SEC'. Instead, it is more probable that ESMA's direct powers and influence will follow the pattern empirically observable so far. ESMA will continue to be an important driver in shaping how EU supervisory governance evolves as a type of 'boots on the ground' supervisor, and this in itself may gradually lead to incremental enhancements of its direct powers, particularly as an accompaniment to the EU's current initiative to develop deeper and more integrated capital markets.

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[169] Eilis Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' (n 13) 137. It is also acknowledged that simple increases in staff and budget may fail to achieve significant change if staff are under-motivated and under-paid, Niamh Moloney, 'Supervision in the Wake of the Financial Crisis' in Eddy Wymeersch, Klaus J. Hopt and Guido Ferrarini (eds), *Financial Regulation and Supervision: A Post-Crisis Analysis* (OUP 2012) 87. See also Howard Jackson and Mark Roe, 'Public and Private Enforcement of Securities Laws: Resource-Based Evidence' (2009) 93 Journal of Financial Economics 207.

[170] Eilis Ferran, 'Understanding the New Institutional Architecture of EU Financial Market Supervision' (n 13); Charles Goodhart and Dirk Schoenmaker, 'Should the Functions of Monetary Policy and Banking Supervision Be Separated?' (1995) 47 Oxford Economic Papers 539, 544. See also Pierre Schammo, 'EU Day-to-Day Supervision or Intervention-Based Supervision: Which Way Forward for the European System of Financial Supervision?' (2012) 32 Oxford Journal of Legal Studies 771, 781 who observes that the fiscal argument is not without its problems if e.g. a smaller Member State is incapable of meeting the financial burden where a market actor fails.

[171] See e.g. European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (n 5). Other Commission proposals include direct supervision by ESMA of data providers; and the direct supervision of pan-EU investment fund schemes.

[172] This report was prepared by the Commission President, the Euro Summit President, the President of the Euro Group, the ECB President, and the European Parliament President, see Jean-Claude Juncker and others, *Completing Europe's Economic and Monetary Union: The 'Five Presidents Report'* (June 2015) (n 4).

[173] Jean-Claude Juncker and others 12. See also e.g. ECB, *Building a Capital Markets Union – Eurosystem Contribution to the European Commission's Green Paper* (2015) 15. A response from the UK House of Lords was less effusive however. It noted that the creation of such a single supervisor was not mentioned in the Commission's CMU action plan; and that the House had previously opposed such a development, House of Lords European Union Select Committee, *'Whatever It Takes': The Five Presidents' Report on Completing Economic and Monetary Union*; see also Bank of England, *Bank of England's Response to the European Commission Green Paper: Building a Capital Markets Union* (May 2015) that observes that the ESAs' current supervisory powers are sufficient and that 'no new measures are required'.

How this is likely to be affected by the current shake-up of the EU caused by the Brexit vote is impossible to predict. At this stage, the most that can be said is that it may reinforce some leanings towards an increased centralisation of powers, including with respect to greater supervisory integration.[174] Indeed, this stance is evident in the Commission's current consultation, which reflects on the changing political landscape and explores areas where extensions to ESMA's direct supervisory powers could contribute to deeper market integration.[175]

One way or another, however, in the field of direct enforcement, ESMA's hands remain tied in a more practical regard. As observed in section 3, the *Meroni* constraints result in ESMA only being able to impose relatively small sanctions via an inflexible procedural framework. Without ESMA being granted the ability (that a national regulator, or ESMA's comparative cousin, the SEC has) to impose sufficiently tough penalties, ESMA will struggle to have any deterrent impact on the dominant market participants. How might this problem best be tackled? First, ESMA's sanctioning policy could be specifically shaped around the objectives of punishment and deterrence (in line with the approach taken in the field of competition enforcement). Linked to this, increasing the upper limit on fines, and directly coupling the penalties to an entity's turnover could help ensure they may have a dissuasive effect in practice.[176] Finally, a more radical proposition could involve granting ESMA limited competence in the arena of criminal penalties, although such a proposal is unlikely to ever gain sufficient political traction.

5. Conclusion

ESMA has, in the main, seized the day with its new role as a direct supervisor. It has shown itself to be a pro-active patroller of the markets that is also prepared to engage with the more politically delicate aspects of its watch. ESMA has acknowledged that it is still at a relatively early development stage with respect to its direct role, but it is building up a reputation as a credible direct watchdog that has also been endorsed politically and internationally.[177]

ESMA is gradually strengthening its influence in this operational area (with a notable recent instance being its negative short selling opinion). This article speculates that ESMA is likely to continue to be a significant driver in shaping EU supervisory governance going forward and this is likely to result in the greater centralisation of supervisory powers, over time. Despite the change in the air following the Brexit vote, the article suggests that it remains probable that future supervisory governance shifts will evolve gradually and in a somewhat unspectacular fashion. Yet when one bears in mind the empirical evidence, ESMA remains in prime position to play a major influence, and none of the barriers to its operation are in fact insurmountable.

[174] Moloney, 'Financial Services, the EU, and Brexit: An Uncertain Future for the City?', 80; Jean-Claude Juncker and others (n 4) 4-5.

[175] European Commission, 'Public Consultation on the Operations of the European Supervisory Authorities' (n 5).

[176] See e.g. ESMA, *ESMA Sanctioning Powers under EMIR and CRAR: Letter to European Commission* (n 76).

[177] ESMA, *Strategic Orientation 2016-2020* (n 12) 15.